BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ETIHYL CORPORATION)

Appearances:

For Appellant: Roy E. Crawford
Attorney at Law

For Respondent: Paul J. Petrozzi
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Ethyl Corporation against proposed assessments of additional franchise tax in the amounts of $25, 661.35, $25, 661. 35 and $43, 443. 13 for the taxable years 1964, 1965 and 1966, respectively.

Appeal of Ethyl Corporation

Appellant, 1/ a Virginia corporation engaged in unitary business operations, was, for many years, the sole producer in the United States of tetraethyl lead (TEL), an antiknock compound used in producing high octane gasoline. Prior to 1958, appellant's two main integrated refineries which accounted for the total production of TEL were located at Baton Rouge, Louisiana, and Houston, Texas. An integrated facility is comprised of hydrocarbon operations, sodium operations and TEL operations. Bulk intermediate products necessary for the production of TEL are manufactured in the hydrocarbon operations and in the sodium operations. TEL, operations consist of an alloy plant, a TEL plant and a blender. Pig lead is combined with sodium in the alloy plant, and then poured into a caster from which a flaker cuts lead sodium alloy. This alloy is combined with products from the hydrocarbon operations in an autoclave in the TEL plant. After further processirig, TEL is blended with dye and additional products of the hydrocarbon operations to produce ethyl antiknock compound,

In 1958, appellant decided to construct a new tetraethyl lead plant in Pittsburg, California, to supply an anticipated increase in demand for high octane aviation fuel. The Pittsburg facility was not an integrated facility. It contained only the TEL operations and required bulk shipment of the intermediate ingredients produced in the hydrocarbon and sodium operations from the Baton Rouge and Houston refineries. **The only ingredient not shipped from Baton** Rouge and Houston was pig lead. As a result, transportation costs were increased and expensive handling and storage of bulk commodities at two distant locations were required.

During the late 1950's and the early 1960's, major technological breakthroughs were achieved in the manufacture of TEL. The time to process a batch in an autoclave was reduced

1/ In November 1962 stock of Ethyl Corporation was purchased for cash by Albemarlk Paper Company. The purchase was followed by a liquidation in which the assets of Ethyl were transferred to Albemarle. Thereafter, the new combiriation changed its name to Ethyl Corporation. For convenience, the enterprise will be referred to as appellant both before and after the acquisition.

from about eight, hours to about two hours. As a result, the efficiency of TEL operations was greatly increased, although no similar advances were made in hydrocarbon or in sodium operations. These technological advances produced an unprecedented increase in the productive capacity for TEL in the United States. However, this increase was matched by an equally dramatic decline in dernand for high octane gasoline. About 1960, kerosene burning jet aircraft were introduced into commercial aviation, sharply reducing the demand for high octane aviation fuel. In addition, an increasing percentage of small cars requiring regular grades of gasoline was sold by manufacturers, further decreasing demand. As a result, demand for appellant's TEL fell sharply to a level from which it has not recovered.

In June 1963, the union workers at the Pittsburg plant went on strike. On August 14, 1963, the workers were notified that the plant would be idled for an indefinite period commencing about September 15 because of the economic factors involved in transporting raw materials and distributing the products produced at the Pittsburg facility.

For some time, appellant's management had been giving serious consideration to the inherent inefficiency of the Pittsburg plant. In a study concluded August 22, 1963, it was determined that the cost per unit of product made at the Pittsburg plant delivered to customers west of the Rockies was over twice as great as the delivered cost of a unit of the same product produced at the Houston or Baton Rouge plants. The study showed that appellant would save $985,000 per year by shutting down the Pittsburg facility and keeping it in a standby condition. However, the study also showed that $1,3 24,000 could be saved by "pulling roots" and permanently closing the facility.

After closing the plant in September, appellant was faced with the problem of disposing of the equipment located there. All general equipment, such as desks, fork lifts, etc. , which had a value to appellant at another location in excess of the cost of transportation was moved from the Pittsburg facility. The remaining integrated equipment was retained in place. No use for most of the

specialized TEL facilities could be made by appellant or any of appellant's competitors due to the excess capacity problems each of them faced. Furthermore, since tetraethyl lead is highly toxic, the specialized equipment was contaminated with lead, further reducing its use in other applications. Therefore, appellant was unable to lease the facilities for either a short or a long term period. Although the property was listed for sale, due to its specialized application and contaminated condition, it was not sold until some time after the years in question.

Late in 1963, one of the two flaker units was shipped to the Houston facility. Flakers are specialized equipment used to cut lead sodium alloy from casters and are unique to the production of TEL. It would take over six months to acquire a replacement flake r. As a result of the removal of the flaker unit, the productive capacity of the Pittsburg facility was diminished by one-half. Although the Pittsburg plant was not dismantled at that time and remained capable of limited production, appellant maintains that it had no use for the facility as a standby plant. Its sole use in a standby status, appellant asserts, would have required selective destruction of the TEL operations at Baton Rouge and Houston by casualty without -damage to the, associated hydrocarbon or sodium operations at those facilities. Appellant considered the occurrence of this combination of events highly unlikely.

The remaining TEL facilities at the Pittsburg location, consisting primarily of the autoclaves, were removed in 1965 and sold to one of appellant's subsidiaries in Greece. The transaction resulted in a loss to appellant. The removal of the autoclaves required the destruction of most of the remaining integrated equipment. Thereafter, the Pittsburg facility was no longer capable of any production.

In 1964, appellant charged off the remaining book value of the Pittsburg facility exclusive of the property which was to be shipped to Greece. Appellant considered this charge to income of $1, 500,000 necessary in order to reflect the worthlessness of the contaminated TEL facilities.

The primary issue for determination is whether the value of the Pittsburg facility should be included in the property factor of the formula used to apportion appellant's unitary income to California for the years in issue. A secondary question is whether the loss on the sale in 1965 of equipment used at the plant was a unitary or a nonunitary loss.

It is respondent's position that until the Pittsburg facility was finally dismantled in 1965 it was capable of contributing to earnings and was properly includible in the property factor of the formula. Respondent also maintains that the loss from the sale of equipment from the Pittsburg plant involved a unitary operation and was, therefore, a unitary loss.

On the other hand, appellant contends that the Pittsburg plant should not be included in the apportionment formula since the property had been permanently removed from the unitary business in 1963 and did not represent the contribution of invested capital to the production of unitary income. Appellant also contests the characterization of the loss on the sale of equipment in 1965 as a unitary rather than a nonunitary loss.

The applicable statute involved in this matter is section 25101 of the Revenue and Taxation Code. During the years in issue section 25101 provided, in pertinent part:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll [sic] value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State; ...

The use of respondent's three-factor property, payroll and sales formula for ascertaining the portion of unitary business income attributable to California has been approved in many cases. (See, e. g., Butler Bros. v. McColgan, 315 U. S. 501 [86 L. Ed.. 991] affirming 17 Cal. 2d 664 [111 P. 2d 334]; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [185 P. 2d 16].) The only limitation on the use of the formula is that it must not be intrinsically arbitrary and must produce a reasonable result. (Butler Bros. v. McColgan, supra; McDonnell Douglas Corp. v. Franchise Tax Board, 69 Cal. 2d 506 [72 Cal. Rptr. 465, 446 P. 2d 313].) The burden of showing that respondent's method of allocation is unfair or, unreasonable is upon the taxpayer. (Butler Bros. v. McColgan', supra,)

The regulation promulgated pursuant to section 25101 for the years in issue provides guidelines for resolution of the issue presented here. That regulation provided, in relevant part:

> Property' factor. Tangible property used should be included in the formula at its California tax base. The property factor will normally include the average value of all real and tangible personal property owned by the taxpayer and used in the unitary business. Leased property is excluded from the factor. Also generally excluded is property owned, but not used in the unitary business. **Thus,** a building is not included in the factor until it is actually used in the unitary business. However, once property has been used in the unitary business, it shall be included in the factor, although temporarily unused for short periods. If the property is permanently withdrawn from unitary use, it should be excluded from the property factor. (Cal. Admin. Code, tit. 18, reg. 25101 subd. (a).) (Emphasis added.)

Thus, the ultimate question for resolution is whether the Pittsburg facility was permanently withdrawn from the unitary business when it was first closed in 1963, as urged by appellant,

or in 1965 when it was no longer capable of any production, as maintained by respondent. Based upon the entire record before us, and for the reasons set out below, we have concluded that the Pittsburg facility was not permanently withdrawn from unitary use until 1965 when it was no longer capable of any production, Until that time the facility was capable of production and remained part of appellant's unitary business although temporarily unused.

In September 1963 the Pittsburg facility was idled for an indefinite period. We are told that the factors which led to this action were a combination of labor problems and the inherent diseconomy of the Pittsburg operation. We do not doubt these reasons nor do we challenge the wisdom of appellant's actions. Nevertheless, after the plant was idled only equipment of general application was removed. The productive equipment remained intact and the plant was capable of full production should it have been needed in appellant's unitary operation. shortly after the plant was closed one of the flaker units was removed. This act reduced the plant's productive capacity by one-half. However, even after the flaker unit was removed the plant remained capable of production, if required. In fact, until the autoclaves were removed and the plant dismantled in 1965, it remained a viable facility capable of contributing to appellant's overall unitary business operations. Only after the plant was dismantled and no longer able to contribute to the unitary operation was the property permanently withdrawn from unitary use. We have held in a similar situation that until a facility was dismantled it was available for use and presumably would have been used had it been economical for appellant to do so. (See Appeal of E. K. Wood Lumber Co. , Cal. St. Bd. of Equal. , July 15, 1943.)

Appellant argues that even though the Pittsburg plant was in a usable condition only a highly unlikely combination of events occurring in the other two facilities would lead to the reactivation of production at the Pittsburg operation. However, the mere fact that an unusual combination of events would have to occur before the plant would be returned to production does not cause a facility, otherwise capable of production, to be removed from the property factor. (Appeal of E. K. Wood Lumber Co., supra.)

Appellant also maintains that the fact that the plant remained capable of limited production should be discounted since it was attempting to sell or lease the facility, although they were unable to do so because of the excessive productive capacity for TEL existing in the industry, and the contaminated nature of the facilities. While. we appreciate the difficulties appellant was faced with, mere attempts to sell or lease a unitary facility otherwise capable of contributing to the overall operations is not sufficient to require the facility to be removed from the property factor. Idleness of a, facility, even for protracted periods, does not alter the unitary character of the property. (Appeal of E. K. Wood Lumber Co., supra; Appeal of Steiner American Corp., Cal. St. Bd. of Equal. , Aug. 7, 1967.)

In support of its position, appellant emphasizes that in 1964 it wrote off the remaining value of the Pittsburg facility on its books and for shareholder reporting purposes. Appellant concludes that this action established that it was management's opinion that the property was worthless and that the facility was permanently withdrawn from the business. We do not agree. We do not believe that a mere bookkeeping entry is a sufficient basis to require the removal of property, otherwise capable of contributing to the unitary operations, from the property factor. Permanent removal of a facility from the unit occurs only after severance from the unitary operations. Here, permanent removal from the unit occurred when the Pittsburg facility was dismantled in 1965 and no longer capable of contributing to unitary operations.

Appellant has stressed two decisions of this board as supporting its position. (Appeal of Union Oil Co. of California, Cal. St. Bd. of Equal., Nov. 17, 1964; Appeal of Ford Motor Co., Cal. St. Bd. of Equal., April 22, 1948.) We find both cases distinguishable. In Appeal of Union Oil Co. of California, supra, certain oil shale deposits were found not includible in the property factor since they had never been part of the taxpayer's unitary operation and because there was no foreseeable possibility that the property would ever be used in the future. Since the property had never been used in the taxpayer's unitary operations, Union Oil is

clearly distinguishable from the present matter. (See Cal. Admin. Code, tit. 18, reg. 25101, subd. (a).) In Appeal of Ford Motor Co., supra, we found that property which had previously been used in the taxpayer's unitary business was converted to a nonunitary use during the year in issue. Here, appellant's property was never converted to a nonunitary use.

Next, we turn to the question of whether the loss on the sale in 1965 of equipment used at the Pittsburg facility was a unitary or a nonunitary loss.

We have held that the gain or loss from the sale of property which is an integral part of the taxpayer's unitary business constitutes a unitary gain or loss. (Appeal of Steiner American Corp., supra; Appeal of W. J. Voit Rubber Corp., Cal. St. Bd of Equal., May 12, 1964.) In view of our determination that the Pittsburg facility was not permanently withdrawn from unitary use until 1965 when the plant was dismantled and the autoclaves were sold, it follows that the loss on the sale was unitary in nature.

In accordance with the views expressed above it is our 'conclusion that respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Ethyl Corporation against proposed assessments of additional franchise tax in the amounts of $25,661.35, $25,661.35 and $43,443.13 for the taxable years 1964, 1965 and 1966, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of March, 1975, by the State Board of Equalization.

John W. Lynch, Chairman

Member

Member

Member

Member

ATTEST: Charles H. Ottoman, Acting Secretary